

**ASSESSMENT MISSION OF
MUNICIPAL FINANCE
PROJECT IN THE CZECH
REPUBLIC**

**COMMENTS AND
RECOMMENDATIONS**

Prepared for

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COMMENTS AND RECOMMENDATIONS

INTRODUCTION

The purpose of this report consists in providing USAID with some financial elements, illustrating, detailing and complementing the main findings summarized to Czech representatives by the Assessment Mission. Some of the Mission's findings are therefore not repeated there (but included in Mrs. Otterbein's report).

The Program was designed to catalyze the integration of municipal infrastructure finance in capital and financial markets, at a time when only a few municipal credits were originated by commercial banks, and when there was some insufficient knowledge about implementing municipal debt sector in Czech Republic. Both TA and MUFIS funding components of the Program were made to be rapidly responsive. MUFIS was rather designed to work as a mediation shell than as a secure municipal lending benchmark. The 3-year phase [1995-1997] has been quite successful in this respect and most of indicators have been met.

It is possible to measure objective facts and figures. However it is difficult to deduct directly the marginal impact or added value of the HG Program. Both components (MUFIS Fund & Technical Assistance) were not closely associated. MUFIS has functioned as a window shell (without any staff) to encourage some lending competition at an early stage for infrastructure municipal finance. It did not directly implement any specific leveraging conditions on financial intermediaries. Still credit volumes indicate that MUFIS has played an important catalytic role since 1995. Its indirect impacts were positive (see following chapters for details) by:

- The number of active competing banks in this sector
- The extension of municipal credit terms (now most of them are long-term credits)
- A reasonable pricing of municipal risks through lower margins

The TA program has played a key positive qualitative role (difficult to measure quantitatively), particularly for municipalities and banks, through various conferences, training and prepared tools. This effort has probably more contributed to the development of the sector (large banks - main current users of MUFIS - would have probably anyway lent to this sector without MUFIS, however probably not so rapidly).

EVOLUTION OF MUFIS PORTFOLIO WITHIN MUNICIPAL FINANCE IN THE CZECH REPUBLIC

MUFIS Current Portfolio

- 30.09.97: * 708 Million Cr. originated and refinanced for 46 credits (leading bank: KB 29 percent of total)
- 30.10.97: * 756 Million Cr. disbursed through 52 credits (61 percent of second HG tranche being used)
- * 10 percent of total long-term (over 4 years) municipal lending by commercial banks (slightly better than in 1996 - 8 percent - when MUFIS was quasi stopped due to a lack of accessible funds)
 - * 7 percent of all commercial bank's lending to municipalities (69 percent being long-term above 4 years in 1996, versus 49 percent in 1995 and 42.4 percent in 1994, which corresponds to significant progress)
 - * 2 percent-2.3 percent of overall municipal debt (including subsidized credits from public lenders)
 - * 3 percent of market-oriented debt (including all municipal bonds, but excluding subsidized credits from public funds or Ministries)
 - * Active Participating Banks: now 6 ones, 2 former others out (still 40 percent of portfolio) soon 2 or 3 new others (including 2 which signed Master Agreements)

MUFIS Compared to the Czech Saving Bank «CS» (still the leading municipal lender)

MUFIS was designed in 1994 to favor a rapid competitive supply of municipal finance, to reduce the starting overwhelming advance or monopoly of Czech Saving Bank (Ceska Sporitelna or CS).

CS Loans to Municipalities (CS data for 30.09.1997)

Balance	Number of Loans	Market Share	Including Long-Term Credits (more than 4 years)
6.184 Billion Cr. (14 billion made since 1992)	1360 (1250 in 1996)	63.4% (total 9.74 billion)	75.4% (4.66 billion Cr.), similar market shares (about half longer than 7 years)

CS's municipal portfolio is made by 60 percent-70 percent of delivered credits to small municipalities (less than 2000 inhabitants: 90 percent of municipalities for 25 percent of population) at least in number of credits (less in amounts). Credits pooling various smaller municipalities were financed despite some legal complexities.

CS is still the dominant lender to all classes of municipal borrowers, but is not monopolistic any longer (used to be de-facto the only lender a few years ago: other banks have found interest to intervene as well).

MUFIS portfolio represents about 1/6 of CS's long-term municipal portfolio (and 1/20 of total amount of originated municipal loans by CS since 1992: imperfect comparison as MUFIS is only active since 1995). Even if more HG tranches were added, MUFIS would represent only a fraction of CS's municipal lending. MUFIS has contributed to catalyze commercial lending to the sector (in particular, the 4 largest other commercial banks: IPB-KB-CSOB-Agrobanka are currently lending to municipalities). MUFIS represents about 25 percent of non-CS municipal long-term loans: HG program has significantly contributed to the development of a sound banking competition on this specific sector.

Deposits from Municipalities in Banks

Stock of deposit balance recorded by CS	Total municipal deposit stocks in banks
8 Billion Cr. 26% of market shares	32 Billion (declined by 4.1 billion during first semester 1997, and by 4.5 billion during first semester 1996: CNB-data)
	Total banking credits to municipalities
	9.7 Billion (3.3 times less than deposits, used to be 5 times more one year ago)

Despite some binding loan collateral requirements, Czech municipalities appear to differentiate banks for different purposes: loans, management of liquidities, placement of their municipal bonds. CS may be in a non-monopolistic but dominating lending position (63.5 percent with particularly many smaller municipalities, versus 95 percent 4 years ago), but has never been in a dominating position for municipal accounts (KB was rather mentioned as a historical leading competitor, whereas IBP recently focused on larger cities).

The management of municipal current accounts is now the driving force for banking competition on global servicing and makes it now more remunerating than long-term loan margins (but less stable streams as well). Municipal loans for infrastructure projects may naturally represent one strategic gate to this global service.

Despite some large and recent deposit withdrawals (confirmed by current deficits: - 3.2 Billion Cr. during first semester 1997, about -6 Billion for whole 1997 Year) which worry

financial authorities (wider total public deficit while the central government is worsening its own debt), municipalities are still net lenders to banks.

When the global municipal debt is considered (including municipal bonds and subsidized public loans), municipalities may be for the first time in 1997 slightly net borrowers, which may legitimate the preparation of some national regulation on municipal debt (which should not be applied through debt levels, but rather through reasonable debt servicing ceilings).

Projected Evolution of MUFIS Portfolio

Second HG tranche (14 Million US\$ borrowed on March 1997) should be fully disbursed by January 1998. The further pipeline declared to MUFIS by banks indicates that the third phase - 10 Million US\$ currently being finalized so that to be made available in February 1998 - would be rapidly consumed by 56 percent. Former plans made by MUFIS proved over-stated particularly in 1995, but the recent acceleration in the second semester of 1997 was correctly predicted by MUFIS. Many banks try to maximize their possible MUFIS-funding because of its preferential below-market conditions. Their origination process remains relatively slow for municipal lending (reported delay of 3 or 4 months, confirmed by the fact that MUFIS recent on-lending acceleration has occurred only 4 months after the rise of market rates: time to prepare an eligible pipeline).

More disbursements may actually even occur during next months, if the third 10 Million US\$ tranche meets similar on-lending conditions from MUFIS, as some banks do not disclosure their pipeline of projects before booking funds to MUFIS (currently only 1-month booking delay authorized, because of MUFIS's limited resources: CS has just been legitimately refused a 50-Million Cr. booking).

Expected distribution between banks of MUFIS funds could look like:

	Once declared pipeline funded (percent)	Versus Now (percent)	Interviewed by	
Komerčni Banka (KB)	29	29	FvA	LC
Investični a Poslovni Banka (IPB)	15	18	FvA	LC
COOP Banka	14	20		
Pragobanka	12	18		
Ceska Sporitelna (CS)	7	1	FvA	LC
Agrobanka	7	8	FvA	

Ceskolovenska Obshodni Banka (CSOB)	6	0	
Union Banka	4	1	
Moravia Banka	3	4	LC
Prvni Mestska Banka (First Municipal Bank)	3	0	FvA

The 5 largest commercial banks (CS-KB-IPB-CSOB-Agrobanka) would take 64 percent of the total (86 percent without Pragobanka and COOP Banka which could not have been active lenders since 1996).

This situation raises a timing problem about any optional next HG tranche (up to 16 Million US\$, if completing the initially scheduled 60 Million US\$). At the current accelerated pace of the Program, a need may occur as soon as May-June-July 1998. This leaves little time to negotiate and implement some necessary technical and institutional changes required. The process could be slowed down, if prevailing on-lending conditions were already modified for the third 10 Million US\$ tranche (unlikely at this advanced stage).

Recent Evolution of Banking Participation in MUFIS Program

In 1995 only 4 banks participated in the Program, despite 7 selected ones (5 then rejected). Hopefully Kreditbanka Plezn signed but did not withdraw funds (since in bankruptcy). Out of the four active initial banks, there were two small ones (Pragobanka and COOP) and two large ones (KB and IPB).

Because of a very unfavorable evolution of their financial situation, the two small banks were cut off from new available funds by MUFIS. They have anyway been for the time being able to repay MUFIS, but their portfolio still represents 40 percent of total originated credits through MUFIS (at worse at risk, at best unused funds in terms of market leverage).

No new bank could join the Program in 1996, as there were no new available funds: this cyclical Program faced a frozen era until March 1997, when a second HG tranche was disbursed and a new selection of participating banks was made. Four candidate banks were rejected by MUFIS (no disclosed name, but for Pragobanka). Sixteen were invited to express their interest by MUFIS: 10 responded positively, including 8 ones which have signed Master Agreements: after KB and IPB (kept from 1995), recent new lenders were: CS, Agrobanka, Moravia Banka, Union Banka (PMB and CSOB also signed Master Agreements and should very soon lend MUFIS funds to their first projects). Waldviertler Sparkasse expressed an advanced interest (this useful presence of a strong niche-focused foreign bank). Mühlviertler Sparkasse, Girocredit, Hypo-bank, Reiffeisen Bank mentioned some interest if they get municipal clients (which may not yet the case). The five largest commercial banks are present (CSOB has not actively participated yet). Most of other banks are of smaller sizes, some are regional, some even participate to the CNB

stabilization program. Some like Moravia Banka (interviewed) cannot be asked to safely transform very short-term resources into long-credits.

Evolution of MUFIS Municipal Sub-Loans

Eighteen new municipal credits were lent by participating banks (at their credit risk) during third Quarter 97. MUFIS has recorded an acceleration (confirmed in next pipeline) of rather smaller average credit amounts for smaller cities (average 8000 inhabitants and 3100 inhabitants if the largest city is excluded, versus a previous average of 12146 inhabitants, and 9122 if the largest city was excluded), delivered mostly under maximum conditions of the Program (12 percent rate and 15-year term).

There has been a sudden rise of submitted projects to MUFIS, probably because of its more favorable financial conditions. One bank reported that the majority of received municipal borrowers present eligible projects to HG's projects. Some banks complained about restricted purposes, notably about housing municipal renovation.

Monitoring Reports indicate no delinquency on MUFIS portfolio, but mention 7 cases of debt-service ratios (expressed as a percent of expenditures) superior to 20 percent. This latter limit may become a regulatory standard at the end of 1998 (but from a current incomes basis). Three reported cases were exceeding 50 percent debt-service ratio (rather due to the co-existence of several credits). One bank (IPB) also mentioned that one client needed to modify its scheduled stream of repayments: IBP had then to require MUFIS's authorization (due to a cession clause, even if repayments back to MUFIS were not modified). MUFIS portfolio tends to behave like the average in the Czech Republic (not much better despite MUFIS positioning comparative advantage).

Growth of Municipal Debt

Contradictory comments appreciate this evolution:

- Municipalities express intentions to leverage more debt because of their growing investment needs, particularly after the floods in some regions. The press mentioned an additional contribution of 6 Billion Cr. from municipal budgets to pay for the repairs, even after taking into account some extraordinary subsidies from the central government. The general infrastructure situation anyway requires an intensification of efforts (no figures reported, but the perspective of the Czech Republic joining EC within 5 Years, may add more pressure). The irreversible reduction of central investment grants (see one indicator of the Program) also convinces more municipalities - even inexperienced in credits for 75 percent of them - to raise debt.

- But municipalities may currently hesitate about borrowing too much of new long-term credits due to:
 - Lower (in real terms) and more uncertain income streams which may affect their repayment capacities (still few or no local taxes - property taxes only represent 3 percent of incomes before shifting to market value tax-basis, lower income-taxes allotments, possible financial impacts despite promises of the newly-created counties).
 - Threatens and restrictions from MoF to get access to more debt (particularly in cases of current deficits, through refused authorizations to issue municipal bonds).
 - Less favorable and more volatile credit rate conditions since 1997-Spring shock (mostly offered variable-rate credits, currently above 15.7 percent, whereas long-term fixed rates could be made at 11 percent-12 percent one year ago).
 - Difficult political timing to raise debt levels (local elections in 1998).

Figures tend to confirm a slower or moderate growth of market-oriented municipal debt in 1997:

Commercial banks (CNB sources):	30.09.1997 9.7 Billion Cr.	31.12.1996 9.2 Bil. Cr. (7 Bil. of long-term)
Municipal bonds:	11.9 Billion (4.6 Billion if excluding Prague in US\$ not locally traded, including Zidlochovice's bond arranged by CMZRB) No new municipal bonds lately issued since to our knowledge	
Total Municipal Debt (MoF sources):	30.09.1997 37 Bil. Cr.	30.06.1997 34.7 Bil. Cr.
		31.12.1996 32.2 Bil. Cr.

The rise of municipal debt has been moderate in 1996 and 1997, and was rather visible through subsidized credits from public lenders. The demand expressed towards state funds like MUFIS and SEF has been more intense, because of its below-market conditions (particularly since the economic shock of 1997).

One bank reported that some municipal clients consider the favorable on-lending conditions from MUFIS Program as a State compensation for lower central investment grants. Such comment indicate how the Program may drift away from market conditions and

from USAID's main initial objectives.

More precision is required in order to appreciate exactly the balance of various subsidized public credits (MUFIS excluded). Monitoring reports provide data on yearly productions (not on net balances). If credits have not been much amortized yet, their total balance should stand close to 7.2 Billion Cr. in 1997. The included State Environment Fund should represent about 4.1 billion of loans (mostly 0 percent-rate until December 31 1996, and 3 percent-rate 7-year-maturity credits since 1997). The SEF has also leveraged through its public guarantee about 0.5 Billion of additional subsidized loans through banks in 1997. SEF's growing size and larger ambition may become a destabilizing and distorting factor for a sound development of market-oriented municipal finance.

The real break-down of various debt municipal exposures is not clear. For example, loans from commercial banks are reported through aggregated CNB's tables at 9.2 Billion at December 31 1996, whereas Ministry of Finances published its own 11.6 billion Cr. figure (according to statements of municipalities, more subject to confusions). MoF also adds some undetermined debt of small municipalities (2.9 billion). Only municipal bonds can be figured out precisely (only 18 issued ones). According to CNB's tables, the total debt in 1996 would only not be 28-29 billion (not 32.2 billion as published by MoF). These differences represent a zone of necessary improvements. The year 1998 may correspond to a more adequate reconciliation of figures, once a better accounting of municipal budgets is universally and regulatory implemented. MoF would disclose more information about municipal debts, for example through an updated indicator-model of Urban Research.

The total amount municipal debt is still very moderate, as it represents 25 percent of total municipal 1997-expenditures (150 billion Cr.). Total deposit stocks left in banks still represent 32 billion Cr. The growth since 1995 has been smaller than the reduction of Central Capital Subsidies. The overall statistical debt service ratio remains inferior to 4 percent, with some noticed contrasted individual situations. Municipal debt risk is still a very small statistical risk, but it may be time to set more securing benchmarks (not on overall debt but rather through repayment capacities).

REVISION OF MUFIS'S POLICY OBJECTIVES AND RISK-MANAGEMENT TOOLS

Should next HG tranches be considered, MUFIS and Program's sponsors should revise objectives according to a realist timetable of available funds in order to optimize MUFIS's impacts and sustainability, as current markets differs from 1994's conditions (now more advanced stage of the municipal finance sector). MUFIS was correspondingly and successfully built as a low-cost non-bureaucratic mediation shell, in order to proceed rapidly to some pioneering disbursements (competing banks taking credit risks).

MUFIS's Policy About Participating Banks Could Be Modified

MUFIS should require from Participating Banks (PB) some regular disclosure of their overall municipal lending portfolio and latest production (including municipal bonds, break-downs by lending rates and terms). This is a key information to use more effectively HG's scarce funds. A new indicator could be set for the Program, measuring the leveraging impact of MUFIS on commercial lending.

Some minimum initial co-financing could be asked to banks (MUFIS keeping the cession guarantee on the whole municipal loan), or MUFIS could refinance with a shorter maturity the bank's municipal loan (a gradual co-financing would then be implied by some different amortization pace).

Banks with a very short-term structure of liabilities (and/or lack of stable over-liquidities which could compensate for term risks as there is a minimum expected percentage of rolled-over deposits), may not be treated as eligible banks by MUFIS Program, because they would hardly leverage any own resources into infrastructure lending during next months (short life of MUFIS and HG at this advanced stage), but would still expose MUFIS to some larger banking risks. Which smaller banks should still be made eligible?

Note (30.06.1997):

Total deposit in banks:	1057 Billion (7 percent over 4 years, mostly below 1 Year)
Total credit portfolio:	1026 Billion (30.7 percent over 4 years)
Total bonds issued by banks:	89.2 Billion (usually over 5 Years by largest banks)

On the contrary some larger big banks could also be limited MUFIS's funding access, as they can already propose some 10-Year discretionary-variable-rate credits to municipalities. A compromise is to be found between these two extreme opposite criteria, for a more efficient use of MUFIS. If no bank is then found and if MUFIS is not given another medium-term life-cycle, MUFIS may just be seen as having terminated its role.

The current selection policy of MUFIS (through CMZRB Staff) consists in applying CAMEL accounting type of analysis on candidate banks: this model is normally rather used to establish limits on interbanking short-term exposure for Pribor, than appraising long-term risks. It may require some modification (the mission could not appreciate its use) and should be regularly applied. MUFIS could set individual borrowing ceilings over some more exposed banks (only for MUFIS risk-diversification purpose, not as in 1995 according to each pipeline of projects).

Despite good promises, why is Agrobanka eligible before a strategic capitalistic partner is found, as this bank still under CNB direct administration because of its stock of bad loans? Why was Pragobanka rejected although it developed with MUFIS in 1995 some prior experience, and has been recently considered as on a better financial track by CNB (one of the five regional bank with Moravia Banka to CNB's stabilization program which offers 7-year liquidities into cash versus bad loans)? We have no information whether MUFIS contacted all banks active in municipal finance field.

MUFIS should also make its policy (banks and municipalities) more transparent. Rejected candidate banks should receive detailed information about the reasons of the decision. MUFIS should privilege conservative selection criteria, as the overall banking picture is still quite fragile. Ten banks were deprived of their license since 1996 and there may be further ones (in cases of volatile liabilities, large loan-losses reserves, aggressive risky commercial policy, bad management, lack of private strategic partners as the privatization process is just starting).

As MUFIS is vulnerable to any banking failure, its only guarantee is the cession on funded municipal loans. MUFIS should then regularly assess these municipal credits, as well as each bank's underwriting municipal lending policy. MUFIS could then prepare some chapters of Monitoring Reports (UR/UI still preparing other sectorial parts), disseminate some best lending recommendations (now no feedback from advanced banks). There are still doubts about MUFIS's capacity (which is not bank to foreclosure collateral, and has no staff) to service a portfolio of unknown municipal credits from a defaulting bank (very little direct loans serviced by CMZRB as well, which is a specific bank activating various public funds and guarantee mechanisms).

At this stage, MUFIS cannot certify that all active PBs have developed a sound and specialized underwriting policy for lending to municipalities (the previous experience in this sector is not treated as a vital criteria of selection by MUFIS, and some banks have not received TA which is developed on a voluntary basis).

The process of funding approval and required documentation is quite light and fast, but should gradually integrate more elements to assess actual risks. On the other hand, MUFIS does not find much comparative advantage to systematically review the presence of all required permits (better done on a random audit basis). USAID should drop the presence of such documents in the authorization process. MUFIS could check whether it could gradually try to set prudential but lighter application standards between banks and municipalities.

MUFIS municipal credits do not appear much different than national or regional surveys (similar percentage of loans with high Debt Service Ratios). MUFIS has not leveraged the well-perceived TA improvements among banks and municipalities, nor has it

used monitoring findings to improve its own risk management.

MUFIS should soon include in its on-lending requirement a maximum overall debt service ratio (set from current incomes), with a possible higher limit for shorter-term credits for small cities. This measure would just anticipate some next regulatory changes (to be supported if compensated by lifting other debt barriers).

Such changes would slightly modify MUFIS's initial role (just mediation shell) towards a possible benchmark role in secure market-oriented lending practice for some better-targeted purposes.

MUFIS's Targeted Policy About Borrowing Municipalities Could Be Modified

Another priority of HG targeting (still under the scenario of continuing activities, at least from reflow) concerns borrowing municipalities. At this stage of market development, MUFIS Program finds no comparative advantage to finance the largest 13 District Cities, nor municipalities which already borrowed from MUFIS. These two cases could be eliminated in a revised policy.

In addition to previous remarks (overall debt service ceilings), MUFIS could also target as a higher priority municipal infrastructure projects with more reasonable cost recovery returns (quite legitimately contrasted now according to the type of projects, but overall too modest to enable a safe development of global municipal debt). The related TA Program should encourage municipalities to develop various forms of contracts and pricing between municipalities and utilities companies. The present situation represents a limit for future growth.

It looks to me more difficult for any future MUFIS to exactly target the ideal borrowing municipal size between medium and smaller municipalities. Medium-size municipalities represented the initial informal target of the TA Program. Some smaller ones (below 2000 inhabitants) are reported to experience more problems to credit access (90 percent of them during last conference), but does it actually mean that competing banks would not finance them? If yes, would MUFIS's presence motivate such lending? Certainly relationships between banks and smaller municipalities need improvement, but most of it may result from further TA actions (simplify application forms, help borrowers to establish multi-year budgetary plans). CS now records more than 800 of such borrowers, and the recent dynamic of MUFIS's portfolio shows that smaller municipalities are financed (for example through KB's aggressive commercial policy, rather than IPB - more interested by large cities).

The major problem of smaller municipalities comes from more volatile future incomes, less capital grants, and relatively larger infrastructure needs compared to smaller budgets. More efforts should be pursued on the national level (targeted distribution of capital grants and allocation of national taxes, development of local taxes) and operational levels (how to fund pooled municipalities: technical problems, particularly legal ones).

I have no knowledge of an actual need and impact of another HG tranche, specifically justified and focused on the financing of smaller municipalities. The magnitude of available funds during next months may anyway remain quite insignificant compared to the expressed needs. There is no economic reason justifying that a small village should only receive subsidized credits, or even equal conditions of a larger municipality with lower debt servicing. This policy objective could be tried, but does not appear obvious after 3 Years of MUFIS's existence.

MUFIS's On-Lending Policy Adjusted To New Economic Environment

The Program should self-adjust its on-lending conditions, so that to:

- Keep attractive features for more targeted users (banks and municipalities)
- Remain closer to changing market conditions (to catalyze funding without distorting market forces)

This situation was found when MUFIS was starting its operations (1995 and 1996). The program was expected to eliminate interest rate risks, as if Czech economy already belonged to developed ones. Uniform unchanged low fixed interest rates could be maintained only if the Czech economy had more stabilized.

The second condition is not respected any longer, resulting in less direct leverage of market resources, some distortion of market pricing of risks and optimal allocation of resources, and more losses to be paid by MoF (through larger recorded foreign exchange losses, which are naturally connected to the rising of domestic Czech interest rates). Banks now mobilize MUFIS because of this latter's below-market preferential conditions with very low costs of long-term funds and unbeatable credit rates. The three largest banks in this sector (CS, KB, IPB) can offer at best from their own resources some variable-rate municipal credits, set according to an individual banking base rate, currently 15.7 percent (basic rate of IPB 16.9 percent minus 1.2 percent for best clients, 15.8 percent as CS base rate applied without margins to good municipalities, 14.5 percent cost of KB's funds before applying its own margin). These higher rates still represent their best offer among all types of credits, because of low conveyed risks and (that means relatively low margins). All rates are modified on a discretionary basis (6-7 times for some banks in 1997). This practice offers little transparency to clients, but looks commonly-accepted under competitive banking. There is no average banking cost of fund index, nor average deposit index. Banks look motivated to obtain the municipal current account (cheap but hot volatile money).

Such announced rates make financial sense, when compared to commercial term deposit rates (about 11 percent-13 percent), Pribor 6 months (about 14.5 percent), once additional costs (obligatory reserves, collecting costs) and risks (liquidity and interest rate risks) are concerned. One year ago only, large banks would offer fixed rate credit rates at about 11 percent-12 percent to municipalities. Quite deep changes occurred on Czech financial markets.

From a municipality's perspective, MUFIS stands at least 3.5 percent below such rates (of course in some exceptional cases, credit rates may be below costs of funds, because of associated expected fees besides the loan).

Longer term (15 Years): the larger banks offer terms to municipalities up to 10 years. MUFIS keeps there a small sensible comparative advantage (even if at that level of credit rate, an additional extension of 5 Years for the amortization would make the loan only 10 percent more affordable). Only CS can still - when necessary - propose credits up to 15 Years. On the opposite, smaller dynamic regional banks - like Moravia Banka - cannot propose any longer term than 7 years. MUFIS's terms should be all the more be maintained, that incentives or requirements would lead participating banks to safely transform part of their resources in this sector.

As a result, all interviewed banks expressed an immediate interest to book more MUFIS's funds. MUFIS is rationally seen as an opportunity for their eligible prepared pipeline. They all asked about chances of further HG resources. Most of them have let UTC or MUFIS promote these credits (exception of Agrobanka) as a preferential state-sponsored program, maybe not to harm their own product.

MUFIS should revise its on-lending rate to banks, so that the resulting credit rate (on-lending plus an estimated 2.5 percent bank's margin) stands below but closer to market rates. Here is a possible methodology:

- **Determine a benchmark market rate**, from which MUFIS's rate is set (benchmark - or + X percent) and pegged, so that final credit rates stand just below market conditions for a municipality. As indicative examples:
 - On-lending at Pribor -2 percent (then now 12.5 percent) and max. credit rate at Pribor +0.5 percent (15 percent or lower).
 - On-lending at Treasury Securities -0.5 percent or -1 percent. (11.5 percent now?), on top of which margin is added.
- **Determine a fixed resulting margin** equivalent of all-in costs, fees and risks of MUFIS (but not foreign exchange risk); (revision with current figures, new tasks, related costs from original 1994-estimations, for example not applied on average 10-Year credits but longer ones, but with some higher operating costs including some staff if MUFIS is to be continued, and possible prepayment risks for fixed-rate credits).
- **Pass on to foreign exchange reserve fund, most of the larger available difference** (by written principle?):
 - **MUFIS on-lending rate - MUFIS margin - Cost of MUFIS funds in crowns** (from US basis with fees) This could mean now more than 1 percent (maybe 1.5 percent - 2 percent) affected to this fund, which could help to much reduce the final large subsidy left to MoF (even if losses conveyed from first

HG tranches may still be superior to this figure). About a half of foreign exchange losses could be covered by this changed lending policy. This would represent much more than MUFIS can now contribute (at best 0.5 percent but in praxis 0.25 percent because of MUFIS own losses (due to low and unstable margin, larger foreign exchange risks) in last 3 Years. The larger the final discount versus market conditions, the lower contribution for foreign exchange reserve fund.

The on-lending pegged rate should not decline below a contractual floor rate: US rate + MUFIS spread. Rising on-lending interest rates drives banks and municipalities to take a larger indirect share of foreign exchange risks. A pegging policy would offer this positive consequence, but is anyway legitimated by the leveraging role of MUFIS on market financial resources towards municipalities.

Proposed Pegging of MUFIS's On-Lending to a Market Rate Reference

Here are some possible proposals among others (maybe menu): decision belongs MUFIS Sponsors:

- If fixed rate: larger prepayment risks for MUFIS (even if partially covered by fees) but scarce attractive conditions in current financial markets (usually offered by banks only for shorter maturities).
- One domestic prudential benchmark could come from Treasury long-term Bonds (currently about 12 percent above 2 Years, with a relatively stable yield curve until 5 Years). They could either be set from the last long-term issuance, or through calculating an average during a given period.
- If floating rate: a natural choice could be the 6-month-Pribor (14.6 percent now, relatively stable but slightly rising) It is already used as a basis for some recent 5-year bond issuance by large banks. It is quite familiar and relatively resistant to shocks. Ideally an average term-deposit index would be preferable, but it does not exist. This benchmark could positively contribute to improve the transparency of some current market lending policy (now discretionary variable rates) through indexed adjustable rates.
- Another option would be a different product (to which MUFIS's municipal image could stick) would set a fixed low real rate (about 4 percent), and would then index both balances and payments on CPI inflation.

Resulting payments would rise at the same pace than inflation (supposed to reflect in average the evolution of municipal incomes). Initial repayments would

then turn out to be at least 30 percent more affordable - on a 15-Year basis - with current inflation rates (9 percent-10 percent, as well forecast for 1998). Similar pattern would be on-lent to PB (rate: inflation + 2 percent for example). But as more work is needed in banks, the proposal remains unlikely.

Another version would apply as an index the average growth of municipal incomes (recorded or planned). These variations make some sense only if inflation is expected to remain moderate (10 percent zone).

- No interviewed bank complained about the maximum 2.5 percent spread imposed by MUFIS (sufficient). Most propose low margins to municipalities for what is estimated as a very good risk and a potential leverage of other placement fees and cheap deposits. MUFIS may now drop the maximum 2.5 percent ceiling on spreads (competition mature enough). It played an useful role at the beginning.
- The major problem about reforms comes from the lack of incentives to change anything (neither municipalities, nor banks, nor MUFIS). Only MoF which is subsidizing the Program, should support reforms. MoF's representative mentioned the necessity to increase on-lending rates. But MoF may not be correctly informed about the level of foreign exchange contingent liabilities conveyed through MUFIS portfolio. And MoF may face other priorities than this project, which may be rather used as a smoothening modest tool in the more global and tense budgetary relationships between central and local governments. Some resistance (at least through some passivity and delays) could be expected.

Better Handling of Foreign Exchange Risks

The current system should be maintained (left final losses to MoF once MUFIS's foreign exchange reserve fund is mobilized) but with a considerable difference: a modified rate lending policy should generate far larger contributions of MUFIS's foreign exchange reserve fund, and eventually lower subsidies paid or to be paid by MoF.

Yearly foreign exchange losses are calculated by applying on US Semestrial installments the difference of foreign exchange rates (between the tranche origination and installment dates). This system is to be maintained, but MoF could also publish for its own information on each HG tranche, the estimation of the total conveyed foreign exchange losses (or gain if appreciated crown since the origination). This other figure would correspond to the yearly difference between foreign exchange rates applied on balance-sheet balances (starting initial exchange rate at date of lent tranche). This sum (reflecting an accounting treatment by banks) would be much larger than MUFIS's accounted losses.

That is why MUFIS cannot assume any banking status (in addition to other consideration like equity and risk concentration). Still this indicative publication would help MoF to better measure its contingent liabilities (to be later paid) from a long-term portfolio exposed to foreign exchange risk in a transition economy. Next budgets could be better prepared (as subsidies are likely to rise with the nominal exchange rate). MoF should be well informed about the real exposure of its guarantee.

As new tranches are disbursed, the whole US\$ sum should not be immediately converted into crowns. In two previous HG cases, this wrong choice has exposed MUFIS to more important risks and losses, because of the high short-term volatility of foreign exchange rates (unfortunate timing of conversion just before some depreciation, following a relatively long period of stability or even appreciation).

Borrowed dollars should be gradually converted according to refinancing needs (as initially planned with the contribution of Dresdner Bank). Foreign exchange losses could have been smoothened. The first HG tranche would have faced a 20 percent - 25 percent depreciation between March 1995 and March 1997 (instead of at present more than 30 percent). The second HG tranche would have faced a 10 percent depreciation (instead of at present 16 percent) since March 1997 up to now (in addition there was no refinancing need expressed before the third quarter). This solution would be easier and cheaper than the purchase of any short-term hedging instrument (swaps are reported to be costly).

A more conservative estimation of foreign exchange rates should be made for each budgeted year. Experts of MoF and CNB should be consulted. Some prudential macro-economic benchmarks should be reminded. In long-term average the crown should still depreciate (by the level of expected inflation differential minus the expected growth or productivity differential +/- corrections from past years of any real over appreciation/depreciation). In the best case, a small appreciation could happen in 1998 (possible correction from 1997 amplified shock). The crown is now more volatile (floating exchange rate, presence of short-term foreign investors).

For example, MUFIS's General Assembly should not have approved in June 1997 the assumptions made for 1997 Budget, of a dollar equal to 30.5 Crowns: even if this hypothesis was valid in March 1997 (when prepared by the Board), foreign exchange rates were already very different in June 1997 (above 34 Crowns). The initial plan was still approved to present an equilibrium of MUFIS's planned results, although actual losses will exceed 10 Million. Reserve funds will be only symbolically used. MUFIS cumulates about 20 million of losses (with past years).

Even under a favorable economic scenario (stabilized nominal crown at 32-33 rate for 1 US\$, which makes little sense beyond 1998 because of stagnant macro-economy, the first HG tranche corresponds to a total foreign exchange loss representing about 25

percent of the loan, and second tranche about 10 percent. In a less optimistic scenario, these losses could respectively reach 35 percent and 15 percent of loans. Compared to actual paid losses (about 0.5 Million US\$), total losses to pay by MUFIS (mainly MoF) correspond to a range between 5 and 9 Million US\$.

No miracle should be expected of a return to the Crown to former initial 26 rate (on the contrary). On long-term credits (30 Years for first tranche and 15 Years for the second), losses correspond to an equivalent additional credit US\$ rate of at least 3 percent. This is quite a high additional cost of funds. This situation (hardly reversible) justified for a modification of the lending policy and foreign exchange reserve funds and a more precise calculation by MoF of implied contingent liabilities.

Further HG funding would reduce these exposures, if proposing reduced terms (15 Years), reduced grace period, and maybe a different composition of borrowed funds (safer to mix with German Marks). But the most important interrogation comes from a comparison with an alimentation by domestic resources (probably cheaper to directly fund MUFIS with some roll-over 5-Year Czech State Treasuries).

Note on Due Installments Since the Origination of the Program

Date due	Date payment order	Amount US\$ (Th.)	Exchange Rate	Cr. (Million)
<i>1 Tranche</i>	<i>US\$ 20 Million US\$ (before withdrawing up-front fees) Rate: 1 US\$ = 25.928 Crowns</i>			
15.09.95	06.09.95	836 (interests) +50 (fee)	27.048	22.6121+1.3524
15.03.96	08.03.96	836+50+1.5	27.245	22.7768+1.3623+0.0342
15.09.96	04.09.96	836+50	26.090	21.8112+1.3045
15.03.97	07.03.97	836+50+1.5	29.535	24.6913+1.4768+0.037
15.09.97	10.09.97	836+50	34.250	30.345 M.
<i>II Tranche</i>	<i>US\$ 14 Million US\$ (before withdrawing up-front fees)</i>			
01.08.97	28.07.97	367.260	34.470 or 34.370?	12.62 Million Cr.

Other Operational Aspects

Some staff should be appointed to prepare and implement some of proposed recommendations (maybe detached from CMZRB). MUFIS's spread or CMZRB's 0.2

percent servicing fee could be risen to reflect additional costs, up to more incentive levels, if necessary and precisely justified. Such was already the initial recommendation formulated by Advisors since 1994, but their opinion was not followed.

MUFIS Supervisory Board may include one rotating member representing PBs, in order to improve MUFIS's knowledge, professionalism and transparency. CMZRB's members should not chair both Boards. No key decision should be taken without non-CMZRB Supervisory Board Members. More generally, these Boards should be regularly opened to new active members (after now 3 years of functioning as a light shell).

The prepayment fee called a reservation fee (1 percent per annum) works until market fund costs don't decline below 8.5 percent. If such was the case (possible if fast macro-economic recovery and Crown pegged to ECU), MUFIS may face additional prepayment risks from banks as municipalities find better conditions. MUFIS does not keep enough equity or margins to cope with this risk. Fees should be risen by another 1 percent for long-term fixed-rate credits (above 10 years?).

There is no coordination about global debt municipal service between MUFIS and SEF (State Environment Fund): at best some gentlemen agreement (expression used by SEF) to sometimes finalize a financial package for some common clients. A more systematic approach for a secure co-financing and some exchange of monitoring data on the debt servicing could be made for common clients. Monitoring Reports sent to SEF?

MUFIS may finance the purchase of municipal bonds by PBs, provided that the investment purpose and the bond's financial characteristics meet MUFIS's conditions. But MUFIS as a mediation shell should NOT be authorized to purchase municipal bonds (no specialist staff appointed in MUFIS, direct exposure to municipal risk, competition with PBs, possible distortion on markets, insignificant contribution to illiquid secondary markets). MUFIS has better activities to run more efficiently. The case met in March 1997 case looks at least very disputable if not worse (bought and kept from CMZRB at a higher rate for a small city).

Could USAID shorten its delays between the initial authorization stage and the final disbursement (in the past at least 10 months)? In 1996 the Program's credibility suffered among banks, which complain about their incapacity to plan their municipal funding with longer delays (CS's recent 1-month booking of 50 Million was rejected as the second tranche will soon expire). Banks had to develop opportunistic instincts about MUFIS. The sustainability of MUFIS has anyway been already hurt.

CS has asked for MUFIS applying to CNB to obtain for PBs an exemption, about the 10 percent obligatory reserve applied to any mobilized liabilities from non-banking institutions (equivalent to net 1 percent on cost of funds). This request is sensible as

MUFIS benefits from a solid State guarantee. On the other hand, MUFIS is precisely treated as a non-bank, in order to avoid significant equity and record current limited foreign exchange losses. Alternative bank's liabilities to MUFIS (deposits, bonds) are also subject to equivalent reserves.

Could MUFIS be audited by Price Waterhouse (CMZRB's auditors), as this Fund is anyway managed by CMZRB? The possible additional costs could be included in MUFIS's revised spread.

Both MUFIS and an interviewed regional bank (Moravia Bank) mentioned their interests to widen US-AID criteria about the eligibility of financed infrastructure projects linked to housing. An unmet demand would come from housing renovation projects on the municipal rental stock (particularly on panel-technology). Market potentials would be very large, as well as the interest of municipalities (effect of close elections?).

I would rather positively consider this demand for a Housing Guarantee Program of USAID, provided that some studies on cost recovery would justify the need of long-term credits (not obvious if minor energy-saving projects), and if rental housing policy makes some economic sense (gradual change of rent policy?).

POSSIBLE DEVELOPMENT OF MUFIS PROGRAM AND RELATED HG PROGRAM

As USAID TA has been announced to gradually close-out (may be spread through one to two years, up to 0.4-0.8 million dollars), the corresponding assistance should be more narrow-focused and the financial rationale of Czech Ministry of Finances may be reduced, given the better-functioning municipal financial markets, the reduced strategic comparative advantage of MUFIS but its larger financial costs.

Some policy decisions should ideally be made explicit rapidly about the future needs of any MUFIS-type institution in the municipal infrastructure finance sector. Subsequently the further quantitative and qualitative needs of any HG resources and/or alternative funding, could be worked out. Time and efforts are necessary to prepare a good HG closing-out, particularly if MUFIS is due to continue funding activities. In case of lack of identified need of continuation, USAID may withdraw its funding after this successful completion of the project, and most of the proposed technical reforms in this report are not worthwhile being implemented.

MUFIS has operated as a financial window vehicle- mediation shell - to accomplish its assigned tasks (minimum). Any future solution keeping any MUFIS basis would require large institutional, technical and organizational changes, particularly if not only relying on further HG funds guaranteed by the Czech State.

[MUFIS Boards (maybe as well UI/UR) have gradually become the main interlocutors of USAID, which is not sufficient to proceed with the new possible directions (particularly if institutionalization of a financial structure, and some policy choices about municipal targets). At this stage, it looks particularly important to restore a direct negotiation frame between US-AID and MoF, where MUFIS would not be systematically invited]

[UTC is expected to feel reluctant about all proposed reforms of the Assessment Mission: in the difficult situation of public deficits, UTC would prefer to optimize the potential subsidy-leverage offered by this rare State Guarantee for municipal finance - up to 100 million US\$].

Most of technical recommendations tend to improve MUFIS's functioning towards the continuation of a more efficient institution, but do not build any institutional solution. Decisions fully belong to Czech Authorities, according to their identified needs. No clear proposal has been made yet. MoF indicated that this topic should be discussed only in one year, as it faces other priorities in this sector (control of municipal debt growth, avoidance of any further State contribution or guarantee, work on future tax incomes of municipalities maybe incorporating a more stable VAT basis- and the financing of newly-created counties).

Four obstacles identified for any sustainable solution following current HG-MUFIS Program

Difficult policy definition of revised targeted objectives. Which specific municipal segments are less covered by market operators? Which potentially-competitive lenders should be helped with long-term resources? There are no easy answer at this more advanced stage of municipal finance markets (partially thanks to both HG Program: MUFIS and mostly TA). There may be no fundamental need for any additional funding. Or the required sums or assumed risks necessary to get any significant policy or leverage impact may just reveal excessive. A clear policy should be made by Czech authorities about the type of lenders and borrowers still in need of such a Program. Institutional designs and financial mechanisms would then result more easily.

Difficult leverage of alternative resources without market distortions and inefficient intermediation. MUFIS management has not demonstrated its capacities to take many initiatives (leverage capital markets, dissemination of secure benchmarks). A pricing as close as possible to equivalent market conditions should be obtained, with some minimal State exposure. In this respect, long-term hard currency money may not be the best option. MUFIS revealed more costly than any State-backed or roll-overed bonds. The proposed reforms for HG would tend to better peg on-lending conditions to market benchmarks and to reduce State's foreign exchange exposure.

Different timing between US-AID and Czech Authorities. USAID needs relatively quick reforms before committing any further HG tranche, whereas Czech side may not feel ready to implement changes, as it has not yet determined any institutional views about this Fund's future.

The Czech side may have been left under the wrong impression that 60 Million US\$ were intangible, and that 100 million US\$ were hoped through the specific State Guarantee approved by the Parliament. The principle volume of 60 million US\$ has been formally accepted within USAID, but does not constitute any commitment (many factors to be taken into account, including the respect of some proposed recommendations). It also appears that the 60 million US\$ rather resulted from a rough break-even estimation for MUFIS in 1994.

Proposed Variants

Announcement of Both HG and MUFIS Closing-out

All major objectives and proposed indicators of the Program have been successfully reached. Some well targeted TA should be maintained during at least 1998 (seminars mostly for municipalities, model updated for indicators, legal credit pool of small municipalities, conference comparing loans and bonds...). Market forces would be then considered to be sufficiently well-established to ensure their own development.

The State should then not restrict municipal debts, but set some debt servicing regulation, stabilize the tax basis of municipal incomes, lift any particular restriction on municipal bonds, offer to investors of such bonds favorable regulatory treatments (like eligible pension funds since 07/1997?).

The only left question in the Program would be about the potential reflows (44 M. US\$ during next 15 Years), which could be recycled into new credits. But the potential yearly production will be very limited (current level divided by a factor 4 or 5, whereas market credits will keep on growing), to justify keeping an active fund. Recycling makes more sense in a scenario where alternative resources are developed (then positive effect). It may be preferable to transfer repayments for MUFIS to CMZRB, which should try to repay as fast as possible US loans (but long grace period and no prepayment before 10 Years on the first tranche at least).

HG Closing-out After Another 16 Million US\$ Tranche, Maintained MUFIS by State-Backed Bonds

State-backed bonds could directly proceed from Treasury Securities (cheaper and more efficient than additional delays and costs of inexperienced MUFIS staff issuing by themselves bonds on capital markets).

According to the exact use of such funds, the main risk comes from possible market distortion and inefficient use of scarce public funds, particularly if the Fund is enlarged. Some of presented recommendations would then be crucial to prepare the operational shift. But so many changes (technical, managerial, strategic) may be required from MUFIS's mediation shell, that this scenario may not look very sustainable in MUFIS today.

A better variant would consist in inviting EBRD to the funding round-table, provided that part of State guarantee could be transferred to EBRD (not obvious). A positive added value would come from EBRD's tight regulations about risk management (MUFIS forced and assisted to implement some risk policy on banks and municipalities) and presence on capital markets (additional lines to banks, leverage in any bond project). Relationships

would probably take time to materialize if MUFIS does not commit some experienced staff to qualify for EBRD's involvement. This track could be followed further on.

Participating banks could also be asked a minority equity contribution to re-capitalize MUFIS (currently symbolic 1 Million Crown capital), if MUFIS's continuation of activities is maintained. Such capitalization would give MUFIS more means to better assess its risks, prepare its own evolution and eventually justify for the choice of this scenario.

CMZRB prepared proposals for a State-funded and/or State-backed Agency, as a continuation of MUFIS or another Fund (either according to MUFIS structure, or to others like its Guarantee Program for SME). CMZRB's main purpose rather consisted in finding an infrastructure or housing purpose, which could receive State financial assistance (pre-condition for its leading involvement). At current stages, two sectors may look interesting in this specific regard: small municipalities and municipal rental housing (renovation and construction), both with the possible support of the Ministry of Local Governments. CMZRB may directly lend credits or guarantee loans distributed by banks. There is no business-plan yet (but discussions for more than one Year). Another year has been quoted to prepare any project. It is not clear whether MoF is kept aware of this project or whether it would disregard it. Interviewed PBs did not look aware of this project. CS mentioned that it would disregard the creation of any bureaucratic State Agency for subsidizing small municipalities (useless and distorted market, better focus on stable incomes for small municipalities).

The State Environmental Fund also declared vast ambitions to expand its subsidized lending and guarantees program, through leveraging more resources to finance more municipal projects (many infrastructure projects can be perceived as environmental). Its size is already far more important than MUFIS, and it disposes of more means and staff. Its municipal debt share stands in a range comparable to municipal lending by banks.

SEF may even more seriously distort municipal finance markets. SEF would already face large repayment problems (despite a major portfolio bulk with 0 percent rate and capital grace periods). A complete audit has just been completed for new SEF's management: HG Program should try to obtain a copy.

SEF could try to focus relatively more its subsidies for smaller municipalities than bigger cities (these latter dispose of more means to pay market loans). SEF plans represent an overall threaten to the system. It can hardly be influenced by USAID. A scenario of a competing MUFIS versus SEF does not look sustainable.

More Ambitious Version of a Municipal Bank

Various versions could be imagined then on a private basis. Such bank could be

specialized in municipal lending and issue its own bonds, or issue municipal bonds on the behalf of its municipal clients (bond bank).

It is unlikely that several competing banks could now participate in such structure. This scenario was examined in 1995 by CS and French CLF, but was temporarily abandoned. The corresponding costs and potential market shares may make such projects premature.

Improvements for Municipal Finance of Mortgage Bond Legislation

Municipal credits (with low risk) could be included as eligible assets to back the issuance of mortgage bonds (developed in Czech Republic with a special license to issue such bonds, but without having to specialize any daughter mortgage bank, to the difference of German banks).

These bonds are secure to investors because of two major principles set in any Mortgage Bond Law:

- They are privileged over any bankruptcy inventory process of the issuer: the portfolio of securing credits would be integrally and immediately transferred to investors' property (probably through a trustee).
- A sufficient volume of selected credits meeting some prudential eligibility rules (maximum loan-to-value, public or mortgage guarantee,...) is covering these bonds through an updated register (always more net amounts and interest rates of credits than bonds).

These Bonds are built to obtain more favorable financial conditions (longer terms, lower rates), thanks to a specific system of assets/liabilities management (an isolated part of high-quality assets is financed only by specific liabilities, which are protected by a special transfer right).

This model has been extensively developed by German Mortgage Banks, which finance considerable amounts of mortgage housing credits as well as local government credits by such bonds (very large markets at competitive price). When a German mortgage bond (*Pfandbriefe*) is issued exclusively to finance local governments, it is called public mortgage bond or communal bond (by opposition to pure private mortgage bonds). German Mortgage Banks issue both types under favorable conditions of volume, rating and spreads. 428 billion DM were recorded as public mortgage bonds as of December 31 1995 (versus 215 billion of private mortgage bonds).

This solution could function relatively easily in Czech Republic, because of the

existence of mortgage bonds. It could work without central State Fund or any subsidies. It would just need some small legislative amendments.

It could exploit all past efforts achieved for the implementation of these bonds: regulation, promotion among investors, fiscal incentives (interests still tax-deductible recently although not the case any longer for Treasuries), disclosure and market operations. It would help to reach faster a critical size effect on the portfolio (cheaper and more liquid), without affecting the credibility of bonds resulting from the high level of security.

Personal Preference

Version N°1 combined with N°4 (too many resistance and drifts expected in other scenarios, no proof of additional funding needs, nor domestic willingness to maintain a Fund with domestic resources).

Still a strong TA program deserved being pursued if financially possible (Training the Trainers for bankers and financial municipal officers, conferences for municipalities, UR indicator model, municipal loan versus municipal bond practical use, BOT cost recovery improvements, best lending practice from advanced banks, work on extended mortgage bonds to municipal finance,...).

All interviewed persons stressed the importance of past efforts and their wishes for some continuation.

I personally consider that this component of the Program has been the most important success-factor for the development of the sector (major credit of UI/UR) even if their outputs are not easily measured (for example, key contribution to the collateral policy of lenders). MUFIS obviously did not take the relay (and is not able to).

As the Team Leader suggested, a working group could be created in order to determine priorities among a very wide potential list. It looks unreasonable after a short assessment mission to recommend or disregard some of the suggested proposals. I would like only to stress there three points:

- A negative factor to be over-come results from the lack of equipped professional training institutions or at least supportive hosts (no strong Association of Czech banks, passive and split UTC,...).
- More feedback should be completed on TA actions (for example, few banks use UR model or even provide added-value comments, no municipal clients - except for imposed policy of young Moravia Banka - has been reported by banks to

have prepared applications with the model's help).

- The sense of priority should be as following:
 - Rather municipalities than banks at this stage as beneficiaries
 - Nothing to MUFIS if not accepted policy recommendations
 - Efforts to make local training sustainable (T&T more crucial than direct assistance like UR)
 - Update and improve use of the existing outputs prepared by UI/UR

Any Lessons?

- Window light structure: ideal to start-up a system, but difficult afterwards to institutionalize or even to adjust its operations to a changing environment. Easy to build, but important to know when to stop.
- Under-estimation of foreign exchange risks on the system (Why Czech perceived as a West economy?)
- Very well perceived program of technical assistance (good lessons about used methods and obtained outputs), but too restricted canals. Start earlier training the trainers program. Try to keep more direct links between both Funding and TA components.
- Include indicators to measure:
 - The direct added value of the Program on the overall market
 - The integration in financial markets (clear rate drift since 1997)
 - The directly imposed leveraging requirement on banks (at least some degree of co-financing)
- Importance even for any light structure to keep a structure open, lively, professional (with some minimum means), relatively independent. Not always the case of MUFIS.
- Keep for USAID some direct negotiations on policy adjustments with MoF.